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Even in such a time of madness as the late twenties, a great many men on Wall Street remained quite sane. But they also remained very quiet. The sense of responsibility in the financial community for the community as a whole is not small. It is nearly nil. Perhaps this is inherent. In a community where the primary concern is making money, one of the necessary rules is to live and let live. To speak out against madness may be to ruin those who succumbed to it. So the wise in Wall Street are nearly always silent. The foolish thus have the field to themselves.

— John K. Galbraith, *The Great Crash: 1929*, 1955

HEADING FOR THE BUST

Observing the crashing stock and bond markets around the world, we have been pondering the root cause. There are many stories, above all fear of accelerating inflation, an associated Fed rate hike and fragility of foreign markets.

The big question is what these crashes truly reflect: orderly unwinding of leveraged bond-holdings, triggered by the new fears of inflation and the Fed's probable rate hike, or disorderly distress selling of bonds by highly leveraged carry traders facing steep losses on their bond holdings, wiping out their equity?

Entering 2004, unbridled economic and financial bullishness held sway around the world. The consensus called for an accelerating global recovery to be led by both China and the United States as powerful engines of growth. Protracted buoyancy in the financial and commodity markets under these conditions was taken for granted. "Reflation play" were the exciting watchwords in the markets.

Relying on the Fed's promise and manifest determination to peg U.S. interest rates at rock-bottom levels, everybody was happy to join the new global play of "reflation trade"; that is, to bet with maximum leverage on rising prices of all kinds of assets, particularly bonds.

Just four months later, the same markets — stocks, bonds, currencies and commodities — are sliding around the world as never before. Definitely, it is far worse than in 2000, regardless of the generally highly optimistic economic forecasts and numerous positive economic news, and although money and credit in the United States and the rest of the world have remained as loose as before. In the United States, bank credit is up $269.5 billion during the first 17 weeks of this year.

Plainly, the Great Reflation Trade of 2003 is coming unglued with a vengeance. U.S. bonds are being crushed. Within a few weeks, U.S. Treasury yields surged to their highest level since July 2002. Agency, corporate and junk spreads are widening again. In some key emerging debt markets, panic has temporarily taken over. In the currency markets, the "commodity" currencies were hit hardest. The biggest loser, though, is Japan's yen.

What is happening? The general view is that the Fed's warnings of a coming rate hike have induced cautious speculators to begin unwinding their positions. We see something very different behind this carnage in global markets: massive global distress selling being triggered by a bloodbath in America's huge carry trade bubble.

It has to be realized that we are looking at a network of global and national asset bubbles that have one main source: a prolonged deluge of money and credit flooding from the United States into the world as a whole. Too many countries unscrupulously swallowed America's excess liquidity through heavy dollar buying by their central banks, thereby preventing or slowing the threatening rise of their currencies.

In 1997–1998, the problem was bubbles in Asia. Today's problem is a global financial bubble with its center

in the United States. Most remarkable and most unusual about the speculative mania that developed during the last few years around the world was its extension across literally all asset classes, covering equities as well as bonds, commodities, real estate and a selection of currencies. As to bonds, the lowest qualities, actually, performed best, as reflected in sharply shrinking credit spreads. What united them all were the floods of extremely loose and extremely cheap U.S. money and credit pouring into the world.

Actually, this year began with some disappointing U.S. economic news. An unexpectedly poor employment report in early January and heavy dollar buying by the Bank of Japan sent the 10-year Treasury yield once more below 4%. In this climate of muted economic expectations, asset prices continued to appreciate. What the speculating financial community clearly likes is weak economic growth, warranting cheap and loose money for eternity. It is the financial speculator's idyll.

But then, a few stronger-than-expected U.S. data for March, reported in April — on employment, retail sales, housing starts and consumer prices (up 0.5%) — abruptly and radically disturbed this idyll. Ever since, U.S. long-term interest rates have been creeping upward. The benchmark 10-year Treasury exceeded 4.8%, up about 110 basis points from its January low of 3.7%.

THE TURNING POINT

In no time, the global "Great Reflation Trade" went into reverse across the board. Given the Fed's repeated warnings of a rate hike in the foreseeable future, it seems reasonable to assume that the better-than-expected U.S. economic news and hints by the Fed of impending rate hikes induced investors and traders to unwind some of their reflation bets sooner rather than later.

We have not bought this explanation. In the past several rate hikes were usually needed from a much higher level before economies and markets reacted. This time the starting point is an ultra-low rate of 1%. Yet the mere thought of a possible small rate hike is virtually causing panic in the markets. This struck us as very odd.

Moreover, we pondered if the great worries in the markets wrongly fixated on possible changes in the Fed's 1% federal funds rate, not on the actual upward movement of long-term rates. If noticed and commented on at all, the usual comforting argument about it was that long-term rates were nevertheless still at a pretty low level by historical standards.

Considerations about U.S. economic growth have to start with the recognition that it depends on a system of interrelated asset and credit bubbles. Among these, the huge carry trade bubble is the indispensable condition for the other bubbles — housing, stocks and mortgage refinancing. We like to think of the huge carry trade in bonds as the mother of all bubbles.

The carry trade bubble is the business of borrowing at the 1% federal funds rate and putting the borrowed money with very high leverage into bonds with much higher yields. But contrary to widespread opinion, the big risk for the hedge funds, banks and other institutions engaged in the carry trade is not in a possible mini-raise in the ultra-cheap borrowing rate set by the Fed, but in a major rise of the long-term rates set by the markets determining the market value of their bond holdings.

Besides, we regard all the Fed's public musings about planning a rate hike as empty rhetoric for the purpose of demonstrating anti-inflation vigilance to the public. Without question, they are well aware of the extraordinary vulnerability of the highly leveraged U.S. financial system, particularly the monstrous carry trade bubble, and also of the risk that any minimal hike in the short-term rate may potentially catalyze heavy bond selling. The looming big risk for the markets and the economy is an uncontrollable increase in long-term rates.

A 4.8% yield for 10-year Treasury notes is, indeed, very moderate from a historic perspective. But the calamity arises from the fact that this rise of the long-term rates by almost 110 basis points has been hitting a market built entirely on extremely high leverage. For the huge crowd of carry trade players, this apparently moderate rise in yields exerted an extremely immoderate effect on the market value of long-term bonds. For them, this spelled disastrous equity destruction.

The rise in U.S. bond yields since mid-March from 3.7% to 4.8% actually slashed the price of U.S. 10-year Treasury bonds from close to 103 to recently close to 94, involving virtually a 9% loss. For the true long-term investor, this would mean the nuisance of a temporary paper loss. But for the carry trader with 20 times leverage and 5% equity, this represents a loss that more than wipes out his whole equity.

DISTRESS SELLING

Like a bolt from the blue, asset values of all classes — bonds, stocks, commodities and certain currencies — began to slide around the globe, far faster than in 2000. Most remarkably, it happened although U.S. monetary policy remained as loose as ever. Fear of Fed tightening has been the immediate general explanation. We could not and still cannot buy that this is able to exert such devastating effects on markets around the world.

Yet the fact that all kinds of assets all of a sudden slumped indiscriminately inherently suggested the existence of some common underlying cause. For us, the mere rise in U.S. long-term interest rates that started in mid-March was the obvious cause. But what was causing this rise?

Observing that both the U.S. bond market and the dollar repeatedly reacted sharply to unexpectedly strong economic news, big job gains in particular, this news was the apparent trigger. Seeking an explanation for the following quick global carnage in bond markets, our focus has always been on the huge, highly leveraged American carry trade community, being suddenly confronted with rapidly rising losses on their bond holdings.

Unquestionably, their lenders were requesting immediate replenishment of their dwindling equity. Complying with this request, the carry traders essentially had to liquidate positions in markets around the world, playing havoc with commodities, bonds, stocks, gold and also various currencies. Not surprisingly, the greatest carnage occurred in those assets and markets in which America's large speculative community had been most heavily engaged.

A most striking and also most spectacular case of this kind is Japanese stocks, involving unusual fluctuations in the yen. Japan, to recall, became a major reflation trade play in the course of 2003 for equity mutual funds in America and Europe. Under the influence of American economists, virtual exuberance developed that Japan's economy was returning to strong economic growth, spelling the end of general deflation. By the way, this occurred against the warnings of the Bank of Japan.

For many months, Tokyo's Nikkei 225 performed best among the stock indexes of the industrial countries, associated with a sharply rising currency. The yen hit its peak against the dollar in early April, at 103, having come from about 121 in July–August. A first sharp upward move, from 118 to 111, occurred in September 2003.

Due to this run into the Nikkei, Japan experienced a huge capital inflow on top of a trade surplus of 136 billion in 2003. Trying to halt or slow the yen's appreciation, the Bank of Japan intervened with dollar purchases of unprecedented size. Within less than half a year, the yen nevertheless gained around 15%, for foreign investors adding, of course, to the gains in the stock market. The bullish consensus predicted a further surge of the yen against the dollar in 2004, to 95. Instead, it is has plunged to 114 at full speed.

Little or nothing has changed in Japan's economy during these months. What radically changed, however, are the conditions for capital flows. The decisive event is the savage liquidity scramble

that has gripped America’s financial community through the bursting of the carry trade bubble.

But now comes the oddest point in this story. Japan’s central bank refuses to accommodate the ensuing capital outflows by selling dollars against the yen. It bought hundreds of billions of dollars when foreign capital poured in, but it refuses to make dollars available for capital outflows. As a result, both the dollar and the euro have been soaring against the yen.

Apparently, the Bank is happy to punish the speculators, letting their capital withdrawal fully impact the exchange rates, with heavy losses for the foreign investors. In no time, the yen depreciated against the dollar and the euro by more than 10%. In the case of China and Hong Kong, with pegged rates to the dollar, American capital returns without losses on the exchange rate.

One last remark about America’s global selling distress: We suspect it creates more losses than liquidity. Where on Earth outside the United States is the financial potency to accommodate American selling that built up with runaway money and credit creation?

AMERICA’S MULTI-BUBBLE SYSTEM

In short, the actual rise in U.S. long-term rates may, indeed, be moderate from the economic perspective, as is generally argued. But for the financial system, governed by preposterously leveraged speculation, it has been a devastating blow.

What next? That is the paramount question, of course, leading straight to two other questions:* First, *could the adverse development in the financial markets that started with the sharp increase in long-term interest rates finally abort the U.S. economic recovery and its asset bubbles? And* second, *what are the actual prospects for long-term U.S. interest rates in the longer run?

Scrutinizing the economic and financial development in the United States during 2003, there cannot be any doubt that the Fed’s systematic manipulation of long-term interest rates to a record-low postwar level played the decisive role in generating the variety of asset and credit bubbles that fostered the protracted consumer borrowing and spending binge.

It enabled the consumer to borrow altogether $879.9 billion in 2003, after $775.7 billion the year before, mainly through rampant mortgage refinancing. The pivotal point to see is that in this way homeowners were able to fund not only higher spending for their living but also extensive house and stock purchases. With inflating prices, the two asset bubbles provided the collateral for the mortgage refinancing bubble.

Manifestly, a precarious system of interdependent asset and credit bubbles developed. But if one of them pops, it essentially crushes the other ones. The first one to succumb in the wake of jumping long-term yields has been the highly leveraged carry trade bubble. Rising Treasury yields pulled mortgage rates back to a level where mortgage refinancing loses its luster. While refinancing at variable rates, linked to the rock-bottom short-term rate, remains cheap, the threat of a rate hike by the Fed tends to put a brake on that, too.

JUST QUIBBLE

To be sure, the pricking of the carry trade forces heavy losses on the U.S. financial community. There should be quite a few trillions of long-term bonds in this game, financed by short-term borrowing. For now, though, there is general denial. In the face of these facts, the intensive discussion about the Fed’s change in semantics concerning its policy intentions strikes us as utterly ridiculous.

The latest version is the comforting remark that “*policy accommodation can be removed at a pace that is likely to be measured*.” While words were changed, the message is in essence the same as before — the Fed will be slow in withdrawing its extraordinary stimulus.

Observing this fuss being made about hair-splitting differences in successive pronouncements by the Fed, we often wonder whether this is really a central bank or a psychiatric asylum where the doctors treat everybody with

the greatest caution.

The apparent underlying idea of this communication farce is to soften the blows of rate hikes to the markets and the economy. It used to be normal for central bankers to want maximum effects for their measures. The Fed is the first central bank in history to want minimal effects when it has to tighten.

Plainly, the Fed is horrified about possibly being forced to hike rates to satisfy market opinion, for two obvious reasons: *first*, they know very well that the U.S. economy and its recovery are much weaker than the public has been led to believe; and *second*, they also know of the extreme fragility of the financial markets and institutions.

Now to the question: Could a protracted bear market in bonds and stocks finally abort the U.S. economy's recovery and its asset bubbles? Our short answer is, of course. Actually, it has started with a vengeance.

Writing this, we notice a headline in an international paper: "*OECD Outlook Bolsters the Dollar*." According to this international agency, the Organization for Economic Cooperation and Development in Paris, the world economy is facing an uneasy two-speed recovery as the United States, Asia and Britain power ahead, leaving much of Europe behind.

Optimism about the U.S. economy is riding high. It is taken for granted that the massive dosage of fiscal and monetary stimulus pumped into the economy and its financial markets last year has created the necessary traction for above-trend economic growth as far as the eye can see.

GROSS POLICY FAILURE IS THE REALITY

Our view is radically different. First of all, the economic growth that has been achieved with unprecedented aggressive monetary and fiscal stimulus is grossly subpar both in its pattern and in its speed. And second, it has to be realized that the power of such aggressive demand stimulus is now largely spent.

In its increasingly desperate attempts to revive the economy, the Fed moreover embarked on unconventional devices, which are not repeatable. One was the explicit public promise to keep the 1% short-term rate for a long time to come; and the other one was the declared intention to bring long-term interest rates down also, by unusual measures if necessary.

In essence, it was an outright plea to America's huge financial community to play the existing steep yield curve with heavily leveraged carry trade. Record-low long-term interest rates were vital to provoke massive mortgage refinancing among homeowners in tandem with massive equity extraction from the family home.

For many Americans, the Fed's "creative" policy of last year was a most successful operation in that asset markets and private households responded with enormous vigor. On closer look, unsustainable, artificially low interest rates created unsustainable, artificial economic growth. The virtuous circle of mounting production, employment and incomes generating "self-sustaining" growth never materialized.

It is our understanding that the economy peaked in the third quarter of 2003. Since then, it has been economic deceleration across the board, in particular in consumer spending. Considering in addition the drastic slowdown in mortgage refinancing, this seems self-evident to us. American statisticians deserve credit for having always managed to fool all the people all the time. We keep trying to be an exception.

TAKING A CLOSER LOOK

In the last letter we explained in detail how the sudden, fabulous surge in payroll employment by 308,000 in March (meanwhile revised upward to 337,000) had come about. Virtually half of the jump — 153,000 — had accrued not from the regular "establishment survey" covering 160,000 businesses and government agencies, but from creative "net birth/death adjustment."

At issue is this mysterious component in the payroll report. Stressing its inability to capture the jobs that new firms generate during an economic recovery, the Labor Department, executing these surveys, has created a computer program called X-12-ARIMA to seize such invisible job creation. Based on statistics covering

1998–2002, a comparison of jobs lost by small firms with jobs created by new firms generated the "net birth/death" ratio that is now stringently applied to measure such invisible job creation. These "imputed" jobs are then assigned to different sectors of the economy.

For reasonable people, it should be clear that today's economic development allows no comparison with that in 1998–2002, a period of frenetic telecom and dot-com startups. The obvious purpose of this computer program is to pretend non-existing accuracy.

Most unusual about these estimated numbers in March–April is only their extraordinary size. Here is the Bureau of Labor Statistics (BLS) table for 2003–2004 of how many jobs it guessed were created by new businesses. The BLS never counted these jobs, and no company reported them. An old friend, the late Al Sindlinger, famous since the 1930s, from whom we first learned these statistical tricks, spoke of phantom jobs.

NET BIRTH/DEATH ADJUSTMENT (IN THOUSANDS):

YEAR	JAN	FEB	MAR	APR	MAY	JUNE	JULY	AUG	SEP	OCT	NOV	DEC
2003				128	192	164	-83	124	33	45	30	62
2004	-321	115	153	270								

SOURCE: HTTP://WWW.BLS.GOV/WEB/CESBD.HTM

For last March the markets had expected about 150,000 new jobs. Instead, the BLS surprised them with a reported stellar increase of 288,000 that boosted the dollar and badly rattled the U.S. bond market. The fact that 270,000 jobs, or more than 90% of this increase, owed to the "imputed" net birth/death rate went generally unmentioned and unrecognized. Actually, very few American economists know about this device at all. For them, the BLS is reporting truly counted numbers.

From the *King Report* (M. Ramsay King Securities Inc.), the only publication known to us for its rigorous scrutiny in checking the U.S. statistics, we learned further that seasonal adjustments in March generated another 157,115 new jobs. Together with the 270,000 from the net birth/death adjustment, the BLS thus created 427,115 new jobs that it never counted.

From the *King Report*: "*Please note that in Q3 when GDP surged, the birth/death rate created only 74k jobs and in Q4 with 4.1% GDP growth 137k jobs were created. Q1 of '04 had a loss of 53k jobs with 4.2% GDP growth. The total (business) 'birth/death rate' jobs created in the previous nine months is 158k. So how are 270k jobs created in one month? How did the April '04 B/D rate adjustment grow from 128k in April '03 to 270k a year later? The facts sure are messy*."

COLLAPSING CONSUMER SPENDING

These and other observations alerted us to take a close look at the numbers concerning consumer spending and GDP growth in general. What we found were some blatant contradictions. Next to badly rattle the U.S. bond market was the report of a jump in retail sales by a surprising 1.8% in March. Following on the heels of the bombastic jobs report, it strongly added to the perception of a booming U.S. economy.

By the way, we have never understood the tremendous attention being accorded to this number because, known to everybody, a large and growing part of this spending is diverted into goods imports, adding nothing to U.S. GDP growth. Moreover, it is in nominal terms. Taking no account of imports and inflation, for the careful observer it is a badly distorted number. But it tends to produce optically big numbers, and that's what Wall Street likes.

Each month, only a fortnight later, the Commerce Department publishes a comprehensive report about "Personal Income and Outlays," both in nominal and real terms. That, though, is finding zero attention. Being aware of the eminent importance of consumer spending, we always carefully check the numbers of this report.

Covering altogether 15 pages, it is probably too boring for the headline-oriented "quick" bullish economists.

To our utter amazement, we found numbers that flatly contradict the bullish retail sales report. Below are the monthly figures for the last two quarters.

PERSONAL INCOME AND OUTLAYS
CHANGE FROM PRECEDING MONTH, BILLIONS OF (2000) CHAINED DOLLARS

	SEPT 03	OCT 03	NOV 03	DEC 03	JAN 04	FEB 04	MAR 04
PERSONAL CONSUMPTION	-16.3	5.5	51.2	40.4	11.5	16.0	9.5
DURABLE GOODS	-14.1	-16.7	9.8	28.3	-40.7	7.0	3.4
NONDURABLE GOODS	-13.1	13.1	27.1	1.7	24.1	-0.8	1.0
SERVICES	8.5	6.6	15.5	14.0	21.5	10.4	5.4

SOURCE: COMMERCE DEPARTMENT, PERSONAL INCOME AND OUTLAYS, APRIL 30, '04, PAGE 12

One number above all struck us. It said that real consumer spending in March had increased by just 0.1%, after 0.2% each in January and February. This compared oddly with the 1.8% reported in retail sales. During the whole quarter, it had risen by 0.5%, or 2% at annual rate, against 3.8% as reported in the official GDP accounts.

According to these data, real consumer spending in the first quarter of 2004 added a mere $37 billion, after $97.1 billion in the prior quarter. We would say this comes close to a collapse. This particular observation, as a matter of fact, is the main reason why we expect shockingly bad news about the U.S. economy in the near future.

The GDP data, on which everybody focuses, tell an entirely different story. They show consumer spending has distinctly accelerated in the first quarter of 2004 to $69.4 billion, from an increase by $59.6 billion in the prior fourth quarter of 2003.

According to the first calculation, consumer spending in the first quarter has virtually collapsed. According to the second calculation, it has even accelerated. How is this possible? In short, it is a grossly distorted comparison.

Arithmetically, both calculations are correct, but they measure different things. The GDP statistics principally compare changes between quarterly averages, while the other calculation measures the increase in spending in the course of the quarter, more precisely, from the last month of the prior quarter to the last month of the current quarter.

Differences between the two kinds of calculations are actually the rule. But this one is of exorbitant size, painting drastically different pictures. It has its reason in the unusually steep rise of consumer spending between September and December, of which only the average has entered the quarter's GDP growth, creating a so-called statistical "overhang" that will add to next quarter's GDP.

From a strictly economic perspective, it should be clear that the steep decline of consumer spending in the first quarter of 2004, as measured by the second calculation, captures the truly relevant economic fact for the U.S. economy in the current year.

GROSSLY IMBALANCED INVESTMENT

It is part of the prevalent bull story about the U.S. economy that strong consumer spending has been joined by recovering business fixed investment, high-tech in particular. Indeed, nonresidential investment has recovered from its low in the second quarter of 2003, after a decline for more than two years. But it is extremely unbalanced investment growth. Measured in percentages, high-tech is the star performer, while all other components remain far below their 2000 levels. For example: structures, –25%; industrial equipment, –17%; transportation equipment, –25%; but residential building, +18%.

This investment pattern does not strike us as being particularly prone to lead an economic recovery. Besides,

it has always been our view that the high-tech sector, accounting for just 5% of GDP, is not large enough to drive any economy by itself.

Decisive for us in assessing the U.S. economy's near-term and longer-term prospects is in any case the sudden slump in personal consumption we have identified. In its wake it will certainly weaken business investment again. Meanwhile, the government and the central bank have largely exhausted their potential for demand stimulus.

IT'S THE BUBBLES, STUPID

The further fate of America's consumer borrowing and spending binge is, of course, the all-important concern at this juncture. In the last year, in particular, it was the key prop to the U.S. economy. If it definitively falters, this is sure to derail the whole economy's recovery.

As pointed out earlier, the creation of the huge carry trade in bonds was crucial in lowering mortgage rates to a level where they provoked the massive mortgage refinancing bubble with its massive home equity extraction. This, in turn, provided the funds that created the simultaneous bubbles in housing and stock prices, furnishing on their part the soaring pseudo wealth or collateral that facilitated the unfolding borrowing binge.

All of a sudden, sliding asset prices have been hammering all these highly leveraged asset and credit bubbles. Ironically, it was the string of surprisingly strong economic data that triggered these troubles. Fretting about higher inflation and a possible hike in short-term rates, heavily leveraged investors started cautionary liquidations. But given the existing extremely high leverage, more and more selling was bound to follow. In short, investors had simply become too optimistic for the artificially low interest rates.

There can be no question that the badly performing financial markets will take their toll on general sentiment in due time. But this change in sentiment would obviously follow the dramatic changes in the markets, for which most people were unprepared. Typically, the just-published OECD report spells pure optimism about the world economy's prospects.

The Quarterly Review of the Bank for International Settlements (BIS) in Basel, Switzerland, published in March, started, under the title *Overview: Appetite for Risk Lifts Markets*, "*Financial markets around the world rallied into the new year, adding to the impressive gains recorded in 2003. Improvements in global growth prospects and corporate finances, coupled with a robust appetite for risk, underpinned increases in equity and credit prices. Not even further revelations of corporate malfeasance seemed to unsettle investors*." We hasten to add that the Bank has been highly critical of this development.

As earlier elucidated, the sudden rise of U.S. long-term rates, starting in mid-March, had its trigger not in bad news, but in unexpectedly strong economic data. For us, it is an unbelievable irony that those highly desired strong employment gains were the needle that pricked the bond bubble.

To quote Ramsay King on this point: "*It will be irony of Biblical proportion if dubious employment gains spook the markets, which then impairs the economy, which in turn costs Bush the election. That irony would be compounded if there was any political maneuvering or pressure to produce great but unwarranted employment numbers*."

For us, and obviously also for Mr. King, it is of unbelievable irony that the prevailing perception of a strongly rebounding U.S. economy is badly flawed in the first place. As pointed out, consumer spending has effectively slumped during the first quarter. What's more, the impairment of the mortgage refinancing bubble is a compelling reason to assume a continuous slump in consumer spending.

To repeat: Thanks to all these bubbles, the American consumer borrowed a mind-boggling $879.9 billion last year, after $775.7 billion the year before. However, far more of the borrowed money went into house and stock purchases, fueling the rise in their prices, rather than into living expenses.

Pursuing the discussion about the outlook for stock markets, it strikes us that the question of potential buyers and their finances is never touched upon. In the late 1990s, the necessary funding came primarily from American and foreign corporations through huge stock buybacks and frenzied merger and acquisition activity. Private

households just jumped on the running bandwagon.

Since 2000, all buying on these accounts has vanished. Last year, private households stepped in as the single crucial buyer. With poor income growth and virtually no savings at their disposal, their stock buying implicitly depended on their heavy borrowing from the mortgage-refinancing source. But with this source now largely depleted, we see a grossly overvalued stock market without any potential buyers. Corporate pension funds are more broke than liquid.

THE TWO MAIN DANGERS

Pondering the further performance of the U.S. economy and the financial markets, our focus is primarily on two aggregates: consumer spending in occupying the critical role in the economy, and on the movement of long-term interest rates in occupying the critical role in the financial markets. In both of them, we see the two main immediate dangers.

Consumer spending in the course of the first quarter of 2004, as pointed out, abruptly slumped to barely $37 billion, after $97 billion in the prior quarter. Considering further that the rise in long-term rates has pricked the mortgage refinancing bubble, we regard the break in consumer spending as definite.

The reported very strong payroll gains — 337,000 in March and 288,000 in April — created great hopes of a comeback of employment with corresponding income growth. Their comeback in a strong way is really the key condition to sustain consumer spending on a high level.

Closer scrutiny of the bombastic employment numbers led us to regard them as most doubtful. Looking for further evidence, we checked the income data. Growth of wage and salary disbursements in the private sector fell steeply to $10.4 billion, from an increase by $23 billion in February. Manufacturing payrolls, by the way, decreased $0.1 billion, in contrast to a prior increase of $3.6 billion.

For us this was the conclusive proof that the pompous employment numbers were chimerical. In any case, it should be clear that what truly matters for consumer spending are the small income numbers, not the big employment numbers.

Our view that the sudden sluggishness of consumer spending during the first quarter is definite and sure to continue has, in fact, several reasons. The Wall Street bulls, unable to see anything negative in the U.S. economy and its financial system, generally presume that the recent crashes of stocks and bonds around the world reflect the financial fragility of those economies and their markets, compared to extraordinary American strength.

They have it completely backwards. The primary source of this global financial turmoil, just as in 1997–1998, is grossly excessive U.S. capital flows playing the steep yield curve between 1% costs for short-term dollar borrowing against double-digit bond yields — often euro- or dollar-denominated — in the emerging countries.

It is another comforting story that “unwinding” of reflation trades has caused the market crashes around the world. First of all, we would say that the losses already incurred in many markets are of a size that definitely no longer qualify as regular unwinding. The alternative is “distress selling” at virtually any price, forced upon the leveraged investors by dwindling equity or fear of growing losses. This is what we are seeing. There is, of course, a world of difference between the two.

A highly leveraged carry trader who expects long-term interest rates to rise ought to unwind immediately because it involves leveraged losses on his bond holdings. But we think that the owners of the existing huge carry trade bubble face a peculiar, even bigger problem. Who will accommodate their potential bond selling at a scale of trillions of dollars?

At the very least, such selling will send yields steeply upwards, even in America. But we assume something far worse. The simple truth is that this extremely leveraged carry trade bubble is far too presumptuous to be possibly absorbed by the community of unleveraged investors. Bond prices will be talked downward with little actual sales. It will massacre liquidity along with values.

This reminds us of a joke about an investor who had been buying the shares of a company that had persistently risen. Happy about his success, he one day told his broker to sell. But the broker asked, “To whom? You are the only buyer of these shares.” Something like that is bound to happen to the carry trade bubble. There are no other buyers to replace the leveraged speculators.

THE GREAT REVERSAL

As explained earlier, we see a far weaker U.S. economy than is generally conceived. Also considering the troubles with the asset and credit bubbles, we think that the huge excesses and imbalances implanted in the economy and its financial system in the past few years are finally coming home to roost. How will this affect the stock market, the bond market, the dollar and the economy? For sure, this will exert decisive influence on the economy.

The probable severity of the U.S. economy’s imminent slowdown is certainly the first critical question. Unfortunately, this most important question is also the most difficult to answer because it involves far more than just economic facts. We wonder very much about its impact on the psychology of consumers, businessmen and investors.

Considering the unbelievable borrowing and spending excesses in the U.S. economy and its financial system during the past few years, it has always been clear to us that such extraordinary economic and financial follies require great faith and overconfidence in the future on the part of the actors.

We consider it possible, if not probable, that a sharply weakening U.S. economy, taking everybody completely by surprise, will shake not only the financial markets. It may well shake, if not shatter, something else of greatest importance. That is the prevailing complacency and overconfidence. This overconfidence has grown from 20 years of virtually uninterrupted bull markets in financial assets.

The easily predictable victims are the stock market and the dollar. But what would happen to long-term interest rates, governing the bond market? It appears quite reasonable to expect a new sharp decline, perhaps even back to the lows at which they fostered the mortgage refinancing bubble to the benefit of consumer spending and the bubbles in housing and stocks. But the thing to see is that these bull runs had their main source in debt and leverage, not in saving and investment.

Last year, it was the monstrous carry trade bubble of bonds that lowered long-term rates to a level where they promoted all the other asset and credit bubbles. For lack of domestic savings, booming Wall Street has essentially been propelled by exponentially expanding credit bubbles. But these credit bubbles have been punctured, implying sharply rising long-term U.S interest over time.

As to a sharply weakening economy, we presume that it will shatter rather than create confidence. We can well imagine that under these conditions the Fed will even lower its interest rates.

AND THE DOLLAR?

In contrast to U.S. stocks and bonds, the U.S. dollar has done exceedingly well against all currencies in recent months. After hitting its low of $1.2838 against the euro on Feb. 18, it gained more than 10%, hovering lately around $1.20.

Actually, the dollar has been performing very differently against other currencies, but for very different reasons. All Asian countries, depending heavily on exports to the United States, have their currency strictly or loosely pegged to the dollar. While Japan’s yen has no explicit peg, it is heavily manipulated by the Bank of Japan’s interventions in the currency markets.

Non-Asian industrial countries generally let their currencies freely float. Yet there are two different groups. Some countries, running current account deficits, owe the strength of their currency to high interest rates and capital inflows. England is the biggest example. Others, among them the Eurozone and Switzerland, owe their currency strength, in contrast, to the strength of their external current account.

The dollar’s long structural decline really started in the early 1970s, but was repeatedly interrupted by major

dollar recoveries. Strikingly, it always appreciates when the U.S. economy recovers relative to the rest of the world, Europe in particular, depreciating when the U.S. economy weakens. What determines the dollar's ups and downs is evidently a mix of structural and cyclical influences.

Plainly, the structural bearish influence determining the dollar's long-term decline is the huge chronic trade deficit. But whenever the U.S. economy strengthens in comparison to Europe, the dollar rises on the back of increasing capital inflows. That is what boosted the dollar last autumn, and that is what has been boosting it again since February.

It is the comforting official and consensus view in the United States — quoting Treasury Secretary John Snow — that the "*current account deficit reflects foremost the strengths of the U.S. economy — high productivity, strong U.S. growth relative to growth abroad and the relative attraction of investing in the robust, dynamic U.S. economy*." In other words, the super-efficient U.S. economy will never lack the capital inflows it needs to fund its mega-current account deficits.

During the years of "new economy" hype, after 1995, foreign investors and central banks actually overfinanced the soaring current account deficit, thereby boosting the dollar in the markets. In 1995, foreign-owned assets in the United States had amounted, at market value, to around $4.12 trillion. By end-2002, they had soared to $9.1 trillion. U.S.-owned foreign assets, on the other hand, increased over the same time from $3.35 trillion to $6.47 trillion. Including the new capital inflows in 2003, foreign net holdings of U.S. assets now exceed $3 trillion, rising at an annual rate of more than $500 billion.

During the "hype years," foreign corporations shoveled enormous amounts into the U.S. stock market by acquiring U.S. firms at record prices. While these flows have literally stopped since the stock market crash of 2000–2001, net capital inflows nevertheless accelerated on account of an incredible surge in foreign buying of U.S. bonds (Treasury, agency and corporate), more than offsetting the steep fall in stock purchases. Still, the dollar depreciated 12% against a group of seven major currencies.

COLLAPSE OF U.S. PRIVATE CAPITAL INFLOWS

Does this confirm the American view that the huge and growing U.S. trade deficit is no problem? By no means! The fact is that private capital inflows slumped after 2000. What prevented disaster for the dollar and the U.S. financial markets were soaring dollar purchases by Asian central banks, not searching for yield but being desperate to protect their export industries against a steep appreciation of their currencies against the dollar.

The biggest dollar buyer by far was the Bank of Japan. Its foreign reserves at end-March 2004 hit a record high of $827 billion, compared to $674 billion at the year's beginning and $470 billion at the start of 2003. In the first quarter of 2004, the Bank intervened 47 times in the currency markets, selling yen for a total of $134.8 billion, by far the highest amount ever.

China's foreign reserves during 2003 soared from $292 billion to $409 billion. Official estimates put the total dollar purchases of Asian central banks last year to about $350 billion. This financed two-thirds of the U.S. current account deficit and 85% of the federal budget deficit. As the foreign central banks principally invested their reserves in U.S. Treasury and agency bonds, their associated large bond purchases importantly helped to lower U.S. long-term rates.

What would have happened to the dollar and U.S. financial markets in the absence of these huge dollar purchases by Asian central banks? *First* of all, the dollar would have collapsed against currencies around the world; and *second*, the plunge of long-term interest rates would have been less pronounced.

As pointed out earlier, mid-March was the inflection point in this development. Then, U.S. long-term interest rates began their recent rise, which happens to coincide with the sudden halt of dollar and bond purchases by foreign central banks. Japan's last dollar purchase took place on March 16.

Private capital inflows into the United States have drastically declined — for good reasons. Their size still

amazes us, considering that at these levels U.S. interest rates lack any attraction for foreign investors other than the Japanese. In the 1980s, when the U.S. trade deficit began to escalate, dollar interest rates were among the highest of the industrial countries. Yet the dollar fell and fell.

The media regularly cite numbers from the monthly report of the U.S. Treasury about net purchases of long-term securities by foreign investors. They are generally highly impressive. In reality, they are heavily distorted. For 2003, such inflows totaled $744.5 billion.

With $181 billion, Japan was the single biggest capital exporter to the United States. But this amount virtually equals the dollar purchases by the central bank. The same applies to the $120.7 billion registered as bond purchases by other Asian countries.

Britain accounted for $164.3 billion of such U.S. capital inflows. Knowledgeable people, through, are aware that much of this money is on account of American hedge funds domiciled in London. What they export to the United States are the dollars that they have borrowed at 1% in the United States. The same is definitely true of the $91 billion that is recorded to have arrived from Caribbean offshore centers. European countries other than Britain bought U.S. long-term bonds for $117.5 billion. In other words, do not take these numbers seriously.

During recent weeks, the dollar got a temporary boost from the popping of the bubbles reared by U.S. financial institutions in foreign countries, both in stocks and high-yielding bonds, involving a substantial repatriation of U.S. capital.

CONCLUSIONS

During the past two to three years, the U.S. economy and its financial system obtained an unusually high dose of monetary and fiscal stimulus. Yet it was really the interplay of three bubbles — in bonds, housing, and mortgage refinancing — that enabled the consumer to sustain his spending at an elevated level, while employment and income growth fell precipitously.

Manifestly, these policies, having involved heavy rigging of markets, were a palliative that prevented worse for the U.S. economy in the short run. But instead of redressing the economic and financial imbalances from the prior boom, these policies propelled them to new extremes. After all, the U.S. economy is now in many ways in worse shape than ever before.

There has been some involuntary unwinding of the global reflation trades. Yet in this respect we have only seen the tip of the iceberg. It is our view that the leverage in the carry trade of bonds in particular has grown to such an absurd scale that orderly deleveraging is impossible.

To point out the obvious that nobody wants to see: The asset and credit bubbles that have been inflating consumer spending — bonds, stocks, mortgage refinancing — are plainly deflating. The property bubble will soon follow for lack of funding. In short, savage deflation for the asset markets, but stagflation for the economy.

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